



FIVE MYTHS ABOUT DEFLATION

According to some analysts, deflation is about to devour the world economy unless inflationary policies are undertaken urgently to prevent it. Quite apart from the fact that we are still far from deflation actually happening (both eurozone and UK inflation are above 2% at present), the idea that deflation must inevitably trigger a self-sustaining depression is simply mistaken.

There are five ways in which deflation is supposed to plunge the world into a spiral of economic contraction. First, once deflation has started, falling prices will make people put off spending, causing prices to fall further, so that businesses and consumers delay spending longer, and so on. Second, with prices falling and the value of debt being fixed in nominal terms, the real indebtedness of households and firms will grow, acting as a drag on the market, as it has in Japan since 1990. Third, nominal interest rates cannot fall below zero because companies and households always have the choice of holding cash, which gives a zero return. Banks cannot therefore offer interest rates below zero to depositors and, as a result, they cannot charge borrowers negative nominal interest rates on loans. The demand for loans will fall, shrinking the banking sector and the economy with it. Fourth, because nominal interest rates cannot turn negative, central banks, which use reductions in nominal interest rates to stimulate the economy, will be powerless to offset the effects of deflation. Finally, with prices falling and nominal interest rates stuck at zero, real interest rates will keep increasing, adding an extra twist to its intensity.

Yet all of these supposed effects of deflation either do not matter much, or are actually the result of inflation being lower than expected (which happens regularly during dis-inflations), or happen because institutions are not adjusted to a potentially deflationary world. They are *not* the inevitable result of falling prices in themselves.

For example, we have experienced falling nominal prices in computers and telecommunications for decades, and although we may think twice before buying that new computer, we do buy it in the end. We do not seem to put off those long distance phone calls at all. That is because it is quite difficult to put off the consumption of many services (haircuts, tax advice), and with services accounting for three quarters of many advanced economies, most activity will be protected from significant delays in purchases.

Real indebtedness rises not only with falling prices, but rather with *any* miscalculation by borrowers of expected future inflation. This is one of the major mechanisms causing recession during dis-inflation.

Nor is it true that interest rates cannot fall below zero. Companies cannot hold billions of dollars in cash around the office for reasons of security. If the costs of warehousing cash in vaults and transferring it physically to make payments are higher than the negative nominal interest rate which banks would want to charge

for taking deposits and making bank transfers, paying the bank to hold and transfer one's money will be acceptable to depositors.

If banks are paid for holding deposits, they will be willing to *pay out* interest on the loans they make, as long as this interest is sufficiently lower than the interest they receive on deposits to cover their costs (including credit risk). Bonds and bills can of course just as easily bear negative interest rates. You simply get less money back at maturity than you paid.

The problem is therefore not one of the impossibility of negative nominal interest rates, but of negative rates in excess of the costs of warehousing and transferring physical cash. In an economy such as the US, where cash accounts for less than 2% of GDP, cash warehousing capacity is very low, so that its price could well be sufficient to accommodate negative deposit rates of several percentage points per annum.

Thus, a slide into a mild deflation of 1-3% annually need not be much to fear. Indeed, much of the world went through such a period during the last three decades of the 19th century. Prices fell steadily, yet growth was robust. This was the golden age of the gold standard. Indeed, this may already be happening today. Those who warn that the US may already be in deflation because price indices underestimate quality improvements and therefore overestimate price increases by 1-2%, forget that this also implies that output growth is underestimated by 1-2%. Four to five percent growth with zero inflation doesn't sound that bad for the US this year.

Of course, a sharp plunge into deflation, as during the Great Depression, would be a different matter. Then prices fell by about 10% per annum. But a sharp deceleration of inflation, from say 12% to 2% over a couple of years, could also be highly disruptive.

Also, after four decades of inflationary bias, some key institutions are not adjusted to a world of potential deflation. For example, the ban on the ECB financing government deficits would need to be changed, so that cash could be pumped into the economy if interest rates could not be driven far enough below zero. Fortunately, the Fed and the Bank of England are not subject to this restriction.

Finally, it is not in principle impossible to impose negative interest rates even on cash. Government could impose a penalty on cash used for tax payments. Since fiat cash derives its value from government's willingness to accept it at par in settlement of tax obligations, such a penalty would depreciate cash compared to electronic payments.

So, with negative nominal interest rates possible, a deflationary spiral need not happen as prices fall. Of course, deflation is no more to be sought than inflation, especially as the costs of devising and introducing "deflation conform" institutions and financial instruments could be significant. But it need not be a catastrophe, and should not be an excuse for abandoning the low levels of inflation we have achieved at such cost over the last 20 years. We are within striking distance of true price stability, which if sustained it in long term would fundamentally change people's attitude towards saving, and lay secure foundations for investment and long term growth. We must not throw this prize away for fear of an imaginary threat.

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